

Improving the Conditions for Enterprise Development and the Investment Climate for Domestic and International Investors in Ukraine:

Legal Issues with regard to Business Operations and Investment*

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Introduction

The Organization for Economic Cooperation and Development ("OECD"), with the support of the European Union, is currently conducting a multi-year project on investment and enterprise development in Ukraine. This Project builds on the results of the OECD's previous reviews of the legal framework for investment in Ukraine conducted in 2001 ("Investment Policy Review") and in 2002 ("Progress in Investment Reform"), and takes into account the most recent developments in Ukraine's legal and business climates. As part of this Project, the OECD commissioned a Survey of international and domestic businesses operating in Ukraine, drawn from different sectors of the economy and different regions of the country (the "Survey"), to identify issues of concern to these businesses regarding key issues of legislation, the legislation's interpretation and legislative gaps affecting investment and enterprise development in Ukraine.

Accordingly, in April and May of 2004, at the OECD's behest, the Russian-Ukrainian Legal Group organized a series of interviews with international and domestic small, medium and large businesses operating in Ukraine, to identify the legal issues of greatest concern to them. The Survey, combined with a comprehensive review of Ukraine's civil, company, antimonopoly and other business laws and regulations, was compiled into this present Report.

Based on the results of the Survey, this Report focuses on Ukraine's new Civil and Commercial Codes, company laws, antimonopoly legislation and other areas of law that are most im-

portant for the investment climate in Ukraine. Together with the Survey, this Report played an integral role in framing the issues that were later discussed at a Roundtable conference held on 19 May 2004 in Kiev (the "Roundtable") and focused on how best to improve the situation for enterprise development and the investment climate for domestic and international investors in Ukraine. Indeed, the Roundtable's findings very closely tracked the observations and suggested courses of action described and laid out in the Survey and in this Report.

The Roundtable discussions highlighted the importance of this Project. Roundtable participants described the present-day legal situation in Ukraine as needing crucial and timely improvements in order to satisfy the requirements of the domestic business sector and attract needed foreign investments. Following up on the ideas and comments expressed in the opening remarks by the representatives of the OECD, the Delegation of the European Commission, the Ministry of Justice of Ukraine and the Verkhovna Rada of Ukraine, all Roundtable participants agreed that establishing a transparent, stable and fair national legal system is essential to attracting a stable flow of foreign investments into Ukraine's economy as well as

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** Russian-Ukrainian Legal Group, P.A. is a law firm that specializes in representing multinational corporate clients doing business in Ukraine and other countries of the CIS region. Detailed information about its practice is available at <http://www.rulg.com/>.

ensuring equitable “rules of the game” for all businesses.

The Roundtable participants also identified the improvement of the implementation of laws in practice as a point of concern, for writing a law is just the first step in a long process. Until a law can be effectively, fairly and consistently implemented, it is not yet a useful part of the legal system. This last issue is crucial, because foreign investors, as well as domestic businesses, are interested not only in a law’s contents, but also in the results that flow from a law’s passage, effective implementation and application. It is for this reason that the recommendations flowing from this Project do not just begin and end with identifying laws that need to be amended or passed. Rather, it will be an ongoing process of identifying legal problems that should be repaired, developing laws, procedures and mechanisms to fix those problems, and then following through to the laws’ practical implementation. These tasks will require close cooperation and collaboration between the private sector and the Ukrainian government, with attendant support and guidance from experts from the OECD, the EU and other international organizations. It is for this reason encouraging that many Ukrainian government representatives have already acknowledged the importance of this Project and expressed their readiness to work cooperatively in implementing its recommendations.

The Roundtable identified four separate areas of Ukrainian law that appear ripe for legislative improvement:

- ! civil legislation (specifically, the Civil and Commercial Codes);
- ! company law;
- ! antimonopoly law; and
- ! other areas of law and regulations that create unnecessary legal obstacles or hidden charges on doing business.

The specific findings of the Survey, Roundtable and Report were as follows:

Civil Legislation

On 1 January 2004, Ukrainian civil legislation underwent a fundamental transformation. The adoption of new Civil and Commercial Codes signified a new age for the national legal system, as these two legislative acts became the new basis for the development of some of the key legal spheres in Ukraine. There is a downside to this, however,

because any defects in the Codes will be magnified in their importance through the promulgation of subordinate legislation built upon them. That is the reason why the Civil and Commercial Codes must be unambiguous, clear and flawless, and consistent with each other.

Months of experience in using the Codes suggest that they are in need of significant improvement. The potential for conflicts, both internal to the Codes and among the Codes and other laws, is substantial. The Survey and the Roundtable focused on the following major problems with the Codes:

- ! Each Code contains provisions that conflict with other provisions of the same Code. As examples, private sector representatives cited conflicting requirements for the form that contracts should take and conflicting rules on identifying the moment various types of contracts take legal effect.
- ! Substantial conflicts exist between many provisions of the Civil and Commercial Codes that regulate the same issues. For example, some corporate forms recognized in the Civil Code are not recognized by the Commercial Code, and vice versa.
- ! Numerous conflicts exist between provisions of the Codes and subordinate laws. For example, the Civil Code requires a contract, to which a legal entity is party, to bear the legal entity’s corporate seal in order to be valid. This requirement undermines the effectiveness of Ukraine’s new laws on the subjects of electronic documents and digital signatures.
- ! Some good ideas contained in the Codes can not be implemented in practice because of gaps within the subordinate legislation. For example, the Civil Code requires that purchases of land be registered with a government agency, in accordance with an unnamed law, before a buyer can obtain title. Theoretically, such registrations should help to bring order to the country’s real estate market, simplify the process of title searching, etc. However, no government agency has yet been empowered to register such purchases of land, and no law on the procedure for registration has been passed.

The above problems hinder the normal operation of businesses in most spheres of the economy, rendering the legal system incapable of regulating certain relationships and protecting the interests of participants in the economy. Moreover, the large number of legislative gaps in Ukrainian civil legislation gives broad grounds for regulatory agencies

and courts to interpret the meanings of the laws and facilitates corruption among the regulators and unfair competition among business competitors. In this regard, the Commercial Code appears to present an obstacle to the development of the free market in Ukraine because its nature and methods of regulation do not support Ukraine's nascent market economy.

For the above reasons, Ukrainian civil legislation requires improvements. The Roundtable focused on:

- ! how best to resolve conflicts between provisions of the Codes that regulate civil relationships, considering whether conflicts among the Civil Code, the Commercial Code and subordinate legislation should be decided in favor of the Civil Code or the Commercial Code; and
- ! how best to enact into law the implementing legislation referred to in the Civil Code, which has not yet been passed, most importantly, the bill on private international law (which covers conflicts of laws rules) currently pending before the Supreme Rada.

Several Roundtable participants argued that the Codes were essentially contradictory in their natures. It was noted that the Civil Code, while containing some problems, can be improved; on the other hand, the Commercial Code embodies concepts that simply do not work within a market economy. It was generally agreed that the conflicts and inconsistencies between the two Codes are so numerous as to make it impossible to bring them into compliance with each other.

It was suggested that the Commercial Code could perhaps be transformed into an act that regulates only legal relations between the State and private companies. Another participant expressed the belief that setting up separate legal regulations for each of the private and public sectors would be dangerous, and that both State-owned and private businesses should be subject to the same legal regulations. Incidentally, this was a point also raised in the Survey. The representative from the Delegation of the European Commission argued that Ukraine should move towards a unified system of legislation, as the EU is doing, with the aim of both eliminating conflicts among legislative acts and simplifying the process of enforcing laws – which is currently one of Ukraine's primary problems. Another participant pointed out that the Civil Code is already an all-encompassing document, echoing a sentiment expressed by respondents to the Survey. Thus, the Commer-

cial Code was not needed at all and should be abolished.

Ultimately, the majority of the Roundtable participants agreed that the Civil Code must be amended and that this can be done without undue difficulty. In contrast, the Roundtable participants cited the Commercial Code's decided tendency towards re-establishing a command economy, for example, its empowerment of the government to dictate the actions of companies and to deprive companies of various benefits and privileges when they do not comply with government demands, should be abolished.

Company Law

The OECD's 2001 *Investment Policy Review: Ukraine* noted several weaknesses in Ukraine's company law regulation, embodied in the Law on Enterprises and the Law on Companies. Ukraine has repaired some of these problems by annulling the Law on Enterprises. Yet, serious problems with Ukraine's company laws continue to disrupt the economic life of the country. In the OECD's 2001 *Investment Policy Review: Ukraine*, the observation was made that it would be desirable to: "develop entirely new legislation for various types of businesses based on relevant provisions of the draft civil code". That, too, has been accomplished by passing the new Civil Code.

Nonetheless, the businesses surveyed feel that Ukrainian company laws can still be improved. Based on comments gleaned from the Survey, the Roundtable focused on the following three issues:

- ! how to resolve overlapping and uncoordinated provisions of the Civil and Commercial Codes that regulate the same issues; clarifications of ambiguous terminology; and problems with the effective application of many of the Codes' important provisions;
- ! the possible removal of incongruous provisions and legislative gaps in the Law on Companies, which is the primary Ukrainian law regulating companies; and
- ! the possible removal of impractical and unreasonable provisions found in the Codes.

All of these problems hinder enterprise development and business operations in Ukraine. They often create bureaucratic obstacles to the free operation of companies, open the door to unscrupulous competitors using legal loopholes to com-

pete unfairly and create a fertile ground for corruption to grow within government agencies and the courts.

At the Roundtable, the following legislative improvements were considered as means to promote enterprise development and operation in Ukraine:

- ! analyzing company law, especially where regulated by the Codes, to identify both internal contradictions within individual laws and conflicts between different laws. While the Report identifies many of the most important contradictions and conflicts, further study and time would be necessary to do a thorough inventory of all desirable revisions;

- ! repealing the Commercial Code, which currently contains internal contradictions and conflicts with other laws regulating the company law sphere; and

- ! taking the OECD's 2001 *Investment Policy Review: Ukraine* recommendation to "develop entirely new legislation for various types of businesses" one step further than was done when these provisions were added to the Civil Code. As has already been successfully accomplished in Russia, separate, new laws should be enacted in Ukraine to regulate each of the most important corporate forms, for example: joint stock companies, limited liability companies, full partnerships, etc. Each such law should accord with the provisions of the Civil Code (as the subordinate Law on Companies often fails to do now) while also providing further details on the workings of the separate types of corporate forms. (Please note that, although the OECD's 2001 *Investment Policy Review: Ukraine* noted that a bill on joint stock companies was due to be submitted to Parliament "shortly", that bill has still not been passed).

In general, the Roundtable participants agreed that the contradictions between, and discrepancies within, the provisions of the different legislative acts in the company law sphere were especially harmful to enterprise development and the investment climate in Ukraine. Thus, the laws need to be brought into harmony with each other. The Roundtable participants concluded that the most effective means of accomplishing this would be to adopt specialized laws regulating each of the several different kinds of companies.

In this regard, it was pointed out that the current version of the bill "On Joint Stock Companies" still lacks several key provisions. For example, mea-

asures to protect minority shareholders' rights still need to be added. Another legal expert added that, as a rule, Ukrainian bills undergo substantial amendment between their introduction to Parliament and their eventual adoption, and that when they ultimately become law, they often do not much resemble their original wording as bills.

The Roundtable participants also identified practical problems caused by regulations affecting the authorized funds of companies, problems with the foundation of corporate branches and limited liability companies, the minimal regulation of joint stock companies in the Civil Code, and discrepancies between legal requirements for founding companies and how these requirements are in fact implemented (as highlighted in the Survey).

Antimonopoly Law

Fair competition is essential to any healthy market economy. Antimonopoly laws seek to ensure that businesses are monitored in the interests of limiting monopolistic and anti-competitive developments, for enterprises develop best and operate most efficiently in an atmosphere of free and fair competition. To promote such competition, the anti-competitive tendencies from economic concentrations, unfair trade practices and coordinated actions among businesses must be restrained.

For these reasons, Ukraine has created a legislative basis for protecting competition and established an independent state body responsible for this sphere of law – the Antimonopoly Committee of Ukraine ("AMC"). Antimonopoly law in Ukraine thoroughly regulates many aspects related to protecting and monitoring competition in Ukraine. It also provides a mechanism for preventing and eliminating monopolistic and unfair competitive acts. Many large, medium and sometimes even small foreign and domestic enterprises doing business in Ukraine have faced the practical consequences of Ukraine's robust antimonopoly laws more than once. For many such companies, dealing with the AMC has become a part of their day-to-day business life in Ukraine.

After reviewing the comments contained in the Survey, the Roundtable identified a few issues as requiring significant reform:

- ! clarifying ambiguous and limiting overbroad definitions of violations;

- ! reviewing the rules against coordinated actions and economic concentrations; and

! eliminating conflicts between certain provisions of Ukraine's Commercial Code and its antimonopoly laws. For example, Article 30 of the Commercial Code seems to ban coordinated actions between companies outright, whereas the antimonopoly laws only subject such actions to regulatory review, and only in certain instances (where the parties to the actions in question meet certain thresholds for size, turnover, etc.). And Article 126 of the Commercial Code calls for Antimonopoly Committee regulation of all acquisitions of control over Ukrainian companies, whereas the antimonopoly laws again regulate only transactions that meet certain thresholds.

Aside from the above issues, the Roundtable participants generally felt that Ukraine's antimonopoly laws reflected the philosophies expressed in European Union and other Western antimonopoly laws fairly well. However, at least one Roundtable participant reported that staffers at the Antimonopoly Committee have expressed reservations regarding Ukraine's low thresholds for antimonopoly review of certain transactions, and a belief that the laws in this sphere were somewhat overbroad. Roundtable participants shared reservations about the Commercial Code, and noted that the Antimonopoly Committee's internal policy was to ignore the Commercial Code where it conflicts with the antimonopoly laws and to prevent other government agencies from attempting to enforce it.

Miscellaneous Hidden Charges and Unnecessary Obstacles

Many other Ukrainian laws create obstacles to enterprise development and require businesses operating in Ukraine to incur unanticipated costs (hidden charges). These unnecessary obstacles and hidden charges generally exert a negative influence on the investment climate in Ukraine, creating an impression that the government is: (i) creating rules that serve little purpose and (ii) hiding the true cost of doing business in the country.

The Survey's results confirmed the existence, in practice, of the obstacles and hidden charges described below, all of which were discussed extensively by the Roundtable.

The "90 days rule". Ukraine imposes severe fines and sanctions when a Ukrainian business fails to receive hard currency proceeds from sales (in case of export contracts), or goods (in case of

import contracts), under its international contracts within 90 days of the due date. Moreover, the fines are not limited to the amounts that the Ukrainian business in question failed to receive within 90 days, meaning that the imposition of fines continues indefinitely and can exceed the original unreceived amount by many times. Creation of a procedure permitting a resident to prove its innocence of capital flight; lowering and limiting (establishing a cap on) fines for violating the law and comprehensively clarifying various ambiguities concerning said rule might all be desirable actions.

Corruption and over-regulation. The level of corruption in Ukraine remains high. While preparing a strategy to combat corruption in Ukraine is beyond the scope of this Project, the Roundtable participants nonetheless felt it necessary to emphasize that the problem of corruption in Ukraine damages the overall business climate and hinders enterprise development. To illustrate, one of the Roundtable participants offered an extremely disturbing description of how this Roundtable participant was at one point "invited" to meet with three government tax and law enforcement officials, who all demanded that the Roundtable participant's business pay more taxes – despite the fact that it was already up to date on all of the taxes it was required by law to pay.

Additionally, Ukrainian law heavily regulates certain types of business activity. For instance, the businesses surveyed cited Ukraine's numerous state inspections and reporting requirements to State agencies as particularly burdensome. Essentially every business interviewed as part of the Survey echoed this point. Indeed, even the government acknowledges the problem. A representative of the State Committee for Regulation & Entrepreneurship pointed out that their Committee routinely receives complaints from many businesses concerning the great number of licenses and permits that companies must obtain in order to do business in Ukraine. The average Ukrainian company undergoes in the neighborhood of 20 different inspections by various regulatory agencies every year. The bill on the licensing system in the sphere of commercial activity currently being considered by the Ukrainian Government, may help alleviate this problem. Roundtable participants were invited to provide comments on this bill.

These problems of over-regulation and corruption, unfortunately, go hand-in-hand, for the greater the "red tape", the greater the opportunity for unethical government functionaries to offer to cut

the red tape for a fee – another point on which both the Survey respondents and the Roundtable participants were in essentially unanimous agreement.

Financing. Many Ukrainian businesses have problems obtaining financing for their projects through bank loans and equity floatation. Banks rarely loan money for more than a one-year term. They also dislike accepting movable property as security for loans, due to a lack of clarity in the rules on pledging and registering pledges of movable property contained in Ukraine's new Law "On Securing Creditors' Claims and Registration of Encumbrances". Meanwhile, the stock market remains poorly developed and in need of improvement. As a result, respondents to the Survey pointed out that financing business activities through equity floatation was not a real option in Ukraine. Both of these problems require attention.

Notarization. Many respondents to the Survey complained about the burdens Ukraine's notarization requirements place on their respective businesses. Many actions performed by Ukrainian companies in their day-to-day business require the involvement of notaries. Sometimes the reason for such involvement is not clear; often, the fees involved are unreasonably high, with no correlation between the price of notarization and the amount of work involved in the notarization. Transaction costs in many cases equal 1% of the value of the transaction described in the document being notarized, and many ordinary, day-to-day transactions, for example, leasing premises for more than one year, require notarization.

Other problems. The above four examples of obstacles and hidden charges are far from being the only important ones. But a detailed investigation of every such hindrance to enterprise development is beyond the scope of this Project. Nonetheless, two particularly troublesome problems should be highlighted: a poor system for adopting and implementing laws and problems with taxation. How laws are adopted and how businesses are taxed both exert great influence

on business, and improvements in both of these processes would have immediate benefits on the Ukrainian economy. Every businessman interviewed as part of the Survey specifically named Ukraine's tax system as a primary obstacle to Ukraine's investment climate and promoting enterprise development.

In conclusion, the Roundtable produced the following main findings:

- ! Ukrainian civil law would be improved by abolishing the Commercial Code, and with it its conflicts with the Civil Code and subordinate legislation, and considerably amending the Civil Code.
- ! Ukrainian civil law also contains many other conflicts between its fundamental acts, which must be eliminated.
- ! In the sphere of company law, the activities of joint stock companies and limited liability companies should be regulated in separate legislative acts.
- ! Ukrainian antimonopoly law seems to be one of the most advanced branches of Ukrainian legislation. However, antimonopoly regulation still needs to be made more predictable and its scope made more focused in order to avoid creating unnecessary regulatory obstacles to doing business in Ukraine.
- ! Miscellaneous hidden charges and unnecessary obstacles abound in Ukrainian law. Close cooperation between private parties, the OECD, EU, international organizations and the Ukrainian government, especially Ukraine's Ministry of Justice and the State Committee for Regulation & Entrepreneurship, will be required if these hidden charges and obstacles are to be removed. In this respect, the OECD and other international organizations are ready to provide comments on drafts of legislative acts, to advise the Ukrainian government on further steps it can take to improve the implementation of Ukrainian legislation and to render any other assistance that the Ukrainian government finds helpful. □